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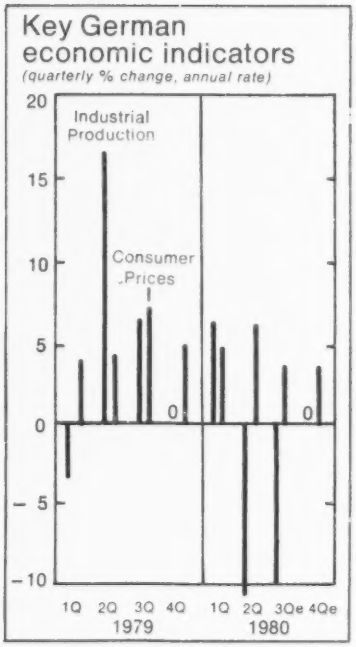
German Monetary Policy Guided by Concern for Mark

The economic recession in Germany is now all but confirmed. Industrial production peaked in March, subsequently declining at an annual rate of 10% in the second quarter. At the same time, the volume of total industrial orders plunged at an annual rate of 20%, with domestic orders falling even more precipitously. Building permits, retail sales, and imports have also shown real declines, and unemployment has risen. German inflation has responded to the economic downturn. Prices in the past two months have risen at monthly rates of 0.2% and 0.1%, respectively, down from monthly rates of about 0.5% in the second quarter. The latest year-over-year inflation rate is 5.5%.

In the past, economic slowdowns of this sort, accompanied by a falling rate of inflation, have led the German Bundesbank to reduce its key discount and Lombard interest rates. Yet so far, these rates have remained at their record levels (both absolutely and relative to inflation). Moreover, the growth of the broad money stock remains at the bottom of the 5%-8% 1980 target range, and the narrow money supply continues to show no growth at all.



What distinguishes monetary policy in the current business cycle from previous policy responses to similar circumstances is the German external-account position. A current-account deficit of 12.7 billion marks was registered in the first half of the year, and a shortfall of approximately 25 billion marks is expected for the year as a whole. This is putting incipient pressure on the mark. But Bundesbank policy is implicitly targeted at maintaining a stable-to-strong mark, both to sustain confidence in a currency increasingly held as an international reserve asset and to stabilize prices. This explains the $6 billion spent defending the DM in the first quarter and the subsequent rise in interest rates to finance the current-account deficit through private capital inflows.

Germany's current downturn is expected to worsen as the world slowdown affects exports, but inflation will continue to ease. Domestic objectives will then be given increasing weight by policymakers. Furthermore, a low inflation rate and the prospect of an improved current-account balance toward yearend should impart greater strength to the DM on foreign-exchange markets. Consequently, German interest rates are expected to decline. This time, however, the extent of the decline will be more than usually determined by developments in Eurodollar and other foreign interest rates.

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Swiss central bank removes obstacles to capital inflows.

The Swiss National Bank recently announced measures that acknowledge the franc's growing role in the international monetary system. Foreign banks are now able to participate in Swiss franc private placements and to take part in franc credits granted by Swiss banks to foreigners—moves which should improve the monitoring of international Swiss franc lending. In addition, interest will now be payable on all foreign-held franc bank accounts. This action marks the final step in removing barriers to capital inflows first imposed in the mid-1970s. It is also aimed at bolstering the franc on foreign exchange markets, since a firm franc remains a key element of Swiss economic policy. The central bank remains concerned about the impact of a buoyant domestic economy on inflation and the balance of payments. A current-account deficit is likely to be recorded this year for the first time since 1965. Consequently, no early relaxation of monetary policy is likely. Indeed, the central bank is expected to lag any moves by the German Bundesbank toward a less restrictive monetary stance.

Denmark adopts tough measures to boost current account, but more is needed.

The Danish economy is now faced with serious problems stemming from its repeated failure to adjust to higher oil prices. Since 1974 export earnings have not risen sufficiently, nor have non-oil imports decreased enough to prevent a huge balance-of-payments deficit. In addition, high inflation and membership in the European Monetary System (EMS) have helped produce an overvalued currency that has further widened the country's current-account gap. The price extracted by the deficit has been mounting international indebtedness. New borrowing necessitated by this year's deficit—estimated at 19 billion kroner (over 5% of GDP)—will boost such indebtedness to about kr. 100 billion (some 28% of GDP) by yearend. Interest payments on the additional debt will absorb 3% of export receipts, further precluding the achievement of current-account equilibrium. To check the widening deficit, the Danish Government is curtailing economic growth by allowing consumers' real incomes to fall and by squeezing investment. GDP is thus expected to decline by 0.5%-1.0% over the course of 1980. This will at best only stabilize the current-account deficit, as much more will be needed to reduce it. At the same time, the continuing high inflation makes the kroner a good candidate for devaluation within the EMS.

Sweden likely to continue dampening domestic demand to ease current-account deficit.

Economic slackening in the United States and Europe is alarming Swedish authorities concerned about the implications for Swedish exports. A 1980 current-account deficit of at least 17 billion kroner is already anticipated, and further deterioration in export earnings would compound the problem. The coalition government, with a parliamentary majority of one, has limited room to maneuver, yet it has managed to raise sales taxes (VAT) to just over 23% on about 60% of all goods and services consumed in Sweden. And in October, the authorities will submit a plan to cut public expenditures by seven billion kroner. Most observers agree, however, that such measures will be inadequate to forestall a further widening in the balance-of-payments deficit, particularly with the May wage settlements adding 11%-12% to incomes. Foreign borrowing of perhaps as much as 20 billion kroner may prove necessary to finance the deficit. Such a level, however, would double the state's foreign debt level from its kr. 20-billion level at the start of the year. A debt of 40 billion kroner, equivalent to about 6% of GDP, is uncomfortably high for neutral Sweden. Accordingly, the authorities are likely to depress domestic demand still further, even if such steps necessitate calling another election during the winter.

Japanese economic slowdown dampening inflation and improving balance of payments.

Confirmation is now in that Japanese economic growth has begun to slow. Nearly all the first-quarter GDP growth was export-related, with domestic demand remaining flat. Economic growth in the second quarter is also likely to have been minimal, based on the small (0.3%) rise in industrial production. The growth slowdown, however, has eased inflationary pressures. Wholesale prices

have moderated since May, with the year-over-year inflation rate down from a peak of 24% in April to 18.5% in July, and the trend continues downward. The domestic economic slowdown is expected to continue through the year, largely the result of steady declines in consumer demand stemming from the erosion in consumers' real incomes. Consumer prices are estimated to rise by an average of about 8% for the year. The current account—in deficit by more than $10 billion for the first six months of 1980—should also see rapid improvement this year as export growth is maintained while imports are curtailed by domestic recession. The expectation is thus for a strengthening of the yen on foreign-exchange markets and a gradual decline in interest rates as the year progresses.

Philippine authorities must reconcile conflicting interests in fight against inflation.

Efforts to curb inflation are creating difficulties for the Philippine Government. Domestic oil product prices were boosted in August, triggering demands for increases in other energy-related products and services and adding to the mounting pressure for wage increases. At the same time, the oil price rises were insufficient to compensate oil companies for the rise in crude prices. This has led to an oil company profit squeeze with potentially serious implications for the economy. On the wage front, Philippine President Marcos responded to labor pressures by raising the minimum wage 13% in August. The trade unions, however, were unsatisfied, while employers argued that such an increase would jeopardize export-oriented industry. Price indexes through May indicate an annual rate of inflation of between 15% and 20%. And the Government's oil price and minimum wage actions are expected to sustain this same high pace of inflation through the second half of 1980.

Argentina achieves reduction in inflation, but industrial problems are a concern.

Argentina has met with a fair amount of success in controlling inflation over the past few months. In August, the annual rate of consumer price increase dropped to 86%, versus 171% in August 1979. The improvement is partly the result of a policy of lagging the monthly exchange-rate devaluation behind the inflation rate, resulting in a real appreciation of the Argentine peso. In addition, a policy of promoting competition with imports is helping bring down prices. This program, however, has led to a sharp rise in imports and a merchandise trade deficit of $500 million in the first half of 1980, compared with a surplus of $1.4 billion for January-June 1979. The import surge has been difficult for import-competing Argentine industries, while the lagging devaluation has hurt exporters. As a result, many firms' profit margins have been squeezed, and labor cuts have occurred. The Government is expected to persist with its program of lagging devaluation, but pressure is building within the business community for a change in course. Despite the trade deficit, international reserves rose to more than $10 billion in August as minimum term restrictions on foreign funds were lifted, partly to assist local firms in meeting liquidity needs.

Iranian economic prospects bleak; hopes hinge on oil export recovery.

The Iranian economy has deteriorated further in recent months. In April, 12 Japanese firms, together with Shell Oil and British Petroleum, ceased purchasing their contracted 850,000 barrels per day of Iranian oil, and pressures from their respective governments have kept them from reversing their decisions. Iran has been unable to locate new markets for its oil, and exports have been cut to approximately one million barrels per day, versus 1.75 million bpd in the first quarter and 2.5 million bpd in the second half of 1979. If exports do not recover —a strong possibility given the present world oversupply—revenue for 1980 will probably total only $13 billion, some $2 billion less than current requirements. The revenue loss will have serious repercussions for the domestic economy, as oil revenues are critical to the health of public finances. Export earnings of $24 billion were originally projected for 1980, and some budget cuts have been necessary. Nonetheless, a large budget deficit is still likely, which will further fuel an inflation rate now estimated at 50%. In the meantime, unemployment is extremely high and economic activity depressed, with few signs of improvement in the offing.

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Retail Trade Shows Unexpected Strength

Retail sales data released last week revealed far more rapid advances than many observers had expected. According to the report, retail sales rose 1.5% in August, well above the small gain that was a general consensus forecast. In addition, July retail sales figures were revised significantly from the 2% increase initially reported to a 3.1% rise.

The overall conclusions to be drawn from the July-August figures are unusually uncertain because of the complexities of price changes. At the moment, however, the stepped up retail sales growth appears primarily to reflect price advances. For example, retail food prices have begun to accelerate sharply. And the 2.8% rise in the dollar amount of retail auto sales—a major contributor to August's total retail trade figure—was accompanied by a modest decline in unit sales. To be sure, some actual sales strength was reflected in other durables, in part related to unusually hot weather and also to the somewhat faster pace of new housing starts.

Overall consumer credit in July was also reported last week. According to the figures, new extensions of credit during the month rose almost $4 billion, to a volume of $24.5 billion—a jump of over 18%. Liquidations were $25.1 billion, resulting in a net decline of credit outstanding of $600 million—the smallest since the drop in credit began in April. The largest contributor to the rise in extensions was auto credit, but most other forms—such as retail credit and credit cards—also showed solid increases. These and other signs suggest a recovery from the constricted credit conditions that accompanied the credit restraint program announced in March.

Although overall credit data for August will not be available for another month, evidence from limited bank data suggests credit expansion since July has remained moderate. Loans to individuals by large banks in August were essentially unchanged from their end-of-July levels. And while the relationship between that series and overall consumer credit is not known with predictive precision, indications are that total credit in August probably rose only slightly, on balance.

In sum, the new retail sales data (including the revisions) suggest slightly stronger "real" spending activity and a pronounced contribution to sales by inflation. As such, they are clearly a source of concern to financial markets. Interest rates have been rising since June, reflecting continuing inflation pressures, some strengthening of economic activity overall, and rapid money growth. There have been widespread expectations, to be sure, of an eventual reversal of the interest rate advance. But the latest retail trade figures are a new source of uncertainty for such an outlook.

Africa and Middle East Bimonthly Survey of Business and Finance

	COUNTRIES	CURRENT BUSINESS CONDITIONS	EXPORTS		GNP IN 1978		BALAN				
			3 months ending	change from year earlier	in billions of dollars	per capita	latest data	reserves (less gold) in million $	12-month change	months of imports covered	li
Africa	Algeria	Oil exploration surcharge of $3 per barrel to be suspended on September 1.	June	+ 59%	24.6	$ 1,374	July	3,482	+ 75%	5.4	
	Botswana	Improvement of investment incentives for labor-intensive industries under consideration.	Mar.	+ 38%	0.4	550	July	340	+ 42%	7.1	
	Egypt	Government considering establishment of holding companies to manage public-sector firms.	Mar.	+ 63%	16.4*	400	June	1,005	+228%	3.3	
	Ethiopia	Military spending saps economy; real economic growth just 2% in 1979.	Mar.	+ 43%	3.1*	105	July	140	+ 20%	2.8	
	Gabon	Last year saw return to positive real economic growth, estimated at 5.7%.	Dec.	+ 47%	3.6*	6,550	Apr.	37	— 59%	1.2	
	Ghana	Industrial utilization rate below 30% attests to continuing economic crisis.	n.a.	—	4.3	385	May	376	+ 40%	4.5	
	Kenya	Slower real economic growth brings decline in per capita purchasing power.	Feb.	+ 43%	6.0*	400	May	534	+ 24%	3.5	
	Madagascar	Real economic growth spurted 10.3% in 1979, while inflation rate accelerated to 14%.	Dec.	+ 7%	2.1	252	May	9	— 72%	0.1	
	Morocco	Several new hotels under construction to enhance revenue from tourism.	Mar.	+ 52%	12.8	678	June	258	— 59%	0.8	
	Niger	Lower uranium prices may bring downward revision of five-year development plan targets.	Dec. '78	+ 51%	1.1	220	May	129	+ 14%	n.a.	
	Nigeria	A 25% jump in federal spending should boost economic activity in second half.	May	+ 71%	50.7*	627	June	8,277	+186%	8.0	
	South Africa	Real economic growth of 7% expected in 1980.	May	+ 40%	57.3*	2,070	May	846	+ 11%	0.9	
	Tunisia	Planned $1-billion investment program aims to double phosphate output by 1990.	Dec.	+ 52%	5.9	966	July	672	+ 83%	3.2	
Middle East	Iraq	A $1-billion contract to establish an electronics industry awarded to a French company.	June	+ 77%	23.3	1,875	n.a.	—	—	—	
	Jordan	Fifteen sectoral committees set up to identify projects for 1981-85 development plan.	Dec.	+ 29%	2.8*	917	July	1,120	+ 12%	7.5	
	Kuwait	Government outlays projected to rise 30% in 1980/81, to $10.95 billion.	June	+ 1%	23.3	18,330	July	3,160†	+ 15%	8.4	
	Saudi Arabia	Economy's real growth rate reportedly 9% in 1979/80, up from 7.5% year earlier.	June	+ 94%	54.5**	8,400	May	22,437†	+ 34%	11.6	
	United Arab Emirates	Private-sector economic activity on upswing.	Mar.	+ 85%	13.8	19,435	July	1,999†	+121%	3.7	

*1979 **FY 1977/78 †Excluding state r

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Rapid Auto Recovery Unlikely

The American automobile industry is anxiously hoping the worst of its troubles are over. After suffering one of their most trying years in history, auto producers are nervously awaiting consumer response to new products intended to bring the industry out of its current depression and back on the road to regaining lost market shares.

Auto industry statistics did show some improvement over the summer months, and in fact, may have contributed disproportionately to boosting aggregate indicators of national economic health. For example, about one-third of the huge 8.4% increase in new orders for durable goods in July—the first positive change in that figure since January—was attributable to shipments in the motor vehicle industry. In addition, the hefty increases in June and July retail sales were considerably more moderate when discounted for price-promotion-prompted auto sales. And further, the biggest positive factor in July's record increase in the Government's composite index of leading indicators—the improvement in the layoff rate—was strongly influenced by fewer new layoffs in the auto industry.

The strength from the auto sector is likely to prove somewhat illusory, however. For one thing, summer is the season for statistical distortions in the industry as assembly plants close down for new model retooling. The timing and duration of this annual ritual are so erratic from year to year that significant revisions in the seasonal adjustment of indicators such as durable goods orders are often necessary.

But more important, any further boost to the economy from autos will be determined by the robustness of sales in the new model year. August sales were not as encouraging as the June-July figures. And at this point, the combination of sustained high inflation and a generally sluggish recovery in other sectors of the economy, coupled with such industry-specific forces as higher new car prices, Americans' recent appetite for imported autos, and the still-limited capacity of producers to turn out the small cars in greatest demand, seem likely to keep sales relatively weak through yearend. Moreover, with interest rates still high, manufacturers want to avoid even a temporary buildup of dealer inventories. As a result of all these influences, the major U.S. producers have set tentative output plans through yearend well below assemblies during the 1974-75 recession and at the lowest level in nearly a decade.

The U.S. Labor Department reported the unemployment rate for the auto industry in August at 21%. This was down significantly from the 29% industry peak in May—and undoubtedly contributed to the surprising drop in the national unemployment rate just at a time when economists expected the labor markets to show further weakening. And while additional reductions in the number of furloughed auto workers are expected, they will be limited unless new auto sales prove to be stronger than expected.

E OF PAYMENTS		MONEY AND BANKING							COUNTRIES
e of IMF edit, mil- of dollars	current influences on paymen.	12-month changes: latest data	consumer prices	latest data	domestic credit	central bank rate	exchange rate in U.S. dollars, September 10, 1980	current monetary conditions	
0	LNG exports to France regaining normal levels.	June '79	+ 14%	Dec.	+ 15%	—	.2620	Credit generally available.	Algeria
—	Diamond output, a source of half export earnings, headed much nigher.	Apr.	+ 12%	Apr.	—205%	5.75%	1.3100	Net foreign assets rise sharply.	Botswana
277	Suez Canal tolls to be raised November 1.	Mar.	+ 20%	May	+ 16%	10.00%	1.4100	Money supply sustains steady expansion.	Egypt
48.2	Oil bill for 1980 equal to about 60% of gross foreign-exchange earnings.	Apr.	+ 11%	Mar.	+ 27%	—	.4840	Money supply level since mid-1979.	Ethiopia
20.1	Net 1980 oil receipts forecast to rise 25%, despite 8% lower output.	Dec.	+ 10%	Apr.	+ 25%	—	.6000	Net foreign assets turn positive in March quarter.	Gabon
68.8	Cocoa receipts in 1980 may fall to $500 mn.; oil bill of $325 mn. foreseen.	Apr.	+ 18%	Mar.	+ 18%	13.50%	.3600	Money supply continues to decline.	Ghana
138.8	Relaxed import controls will widen current-account gap to over $600 mn.	Apr.	+ 15%	Apr.	+ 14%	—	.1400	Selective credit restraint continues.	Kenya
12	Despite higher export receipts, 1980 current-account gap could widen.	Apr.	+ 17%	Sept. '79	+ 48%	—	.2430	Budget deficit likely to sustain credit growth.	Madagascar
194	Despite higher phosphate prices, first-quarter trade gap larger than in '79.	June	+ 10%	May	+ 11%	n.a.	.2630	Euroloan of $250 million signed August 26.	Morocco
—	Fruit and vegetable exports fall.	May	+ 11%	May	+ 39%	10.50%	.0048	Credit to private sector expands briskly.	Niger
—	Measures adopted to woo foreign investment in agriculture and housing.	Sept. '79	+ 11%	Dec.	+ 2%	5.00%	1.900	Record net foreign assets expand money supply.	Nigeria
—	A $250-million Eurocredit obtained.	June	+ 15%	Apr.	+ 18%	7.00%	1.320	Cut in money supply expected.	South Africa
32	Crude petroleum revenue rising steadily.	May	+ 10%	Apr.	+ 6%	5.75%	2.520	Joint investment bank to be set up with Kuwait.	Tunisia
0	Oil output averaged 3.5 million bpd in first half, up 6.6% from year earlier.	Sept. '79	+ 8%	n.a.	—	—	3.390	Credit generally available.	Iraq
0	First-quarter phosphate export value up 57% from like 1979 period.	Apr.	+ 14%	May	+ 24%	6.00%	3.420	Money supply rising.	Jordan
0	Budget projects oil revenue of $16.8 bn. in 1980/81, up 44% from 1979/80.	Dec.	+ 6%	May	+ 30%‡	—	3.730	Ban lifted on trading non-Kuwait Gulf firms on stock exchange.	Kuwait
0	Government expected to cut oil output and boost prices in fourth quarter.	Mar.	+ 2%	Feb.	+ 84%‡	—	.2980	Claims on private sector growing rapidly.	Saudi Arabia
0	Abu Dhabi trade surplus $8.67 billion in 1979, up 54% from 1978.	n.a.	—	May	+ 3%	—	.2680	Legislation to set up central bank approved.	United Arab Emirates

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‡Private sector only

World Interest Rates

market rates of Sept. 10, 1980; bond yields as of Sept. 5, 1980

in percent per annum	U.S.	Canada	Britain	Belgium	France	Germany	Italy	Netherlands	Switzerland	Japan
Central Bank Discount Rate	10.00	10.57	16.00	12.00	9.50	7.50	15.00 penalty rate 18.00	9.00	3.00*	8.25
Day-to-Day Money	10.25 Sept. 11	10.25	16.00	11.15	11.25	9.50	16.875	10.375	5.00*	11.4375
Treasury Bills 91-day, Middle Rates	9.98	10.40	14.50	12.35	12.02 one-year	n. a.	14.849 80-day	no dealing	no market	6.75 2-month
Commercial Paper * prime, 3-month, asked	10.25 finance paper	10.60 finance paper 15% tax w/h	13.8859	11.60 Certified	11.875* Interbank	no market	no market	no market	no market	not traded
Bankers' Acceptances 3-month, asked	10.55	10.55 15% tax w/h	14.875	11.60 Certified	not traded	9.90	20.20	no market	4.50*	no market
Government Bonds Long-term, new and old issues, average yield	11.04	12.90	13.25	10.821 20% tax w/h	12.68	7.99	15.64	10.06	4.91*	8.501
Industrial Bonds prime, long-term, new and old issues, average yield	12.35 Aa Industrials	13.50	14.03	14.977	12.88	8.16	15.90	10.57	5.625*	7.33
Bank Short-Term Rate to Best Borrowers (prime rate)	12.00	12.25	17.00	15.75	13.85	11.50	19.625	12.00	5.50*	8.50
Bank Time Deposits 3-month	10.50 Cert. of Dep.	10.35 Cert. of Dep.	15.625	12.30	11.8125	8.75	10.75	10.625 large deposits	5.75* residents only	6.00 20% tax w/h
Eurocurrencies 3-month, asked	11.6875	no market	16.125	no market	12.25	8.625	no market	10.625	5.50	no market
Exchange Rates—in U.S.$ rates floating against the $	—	.8596	2.404	.03509	.2421	.5622	.001182	.5168	.6135	.004619
Forward Exchange Cover 3-month, in percent p.a. *D* = discount, *P* = premium	—	1.00 *P*	4.00 *D*	.75 *D*	.375 *D*	3.00 *P*	12.25 *D*	.75 *P*	6.00 *P*	1.00 *D*

Eurodollar Deposits
(London, interbank, bid)
Sept. 11

7-day	10.125
1-month	10.75
3-month	11.50
6-month	11.6875

International Arbitrage
(3-month, hedged) + *in favor of U.S. dollars*

U.S.-U.K. Treasury Bills	− .32
U.S.-Canada Treasury Bills	−1.03
U.S.-Canada Finance Co. Paper	−1.20
Eurodollars-U.K. Local Auth. Deposits	0.0

Eurobonds
(average yield on recent straight debt issues)

U.S. Dollar Bonds	
7 yrs. and under	12.50
Over 7 yrs.	12.25
DM Bonds	
7 yrs. and under	7.45
Over 7 yrs.	7.45

Gold Price
London afternoon fixing
686.50
(per fine ounce)

The above interest rate quotations refer to the past week and may not be construed as offers by The Chase Manhattan Bank. The quotations for Bank Short-Term Rate to Best Customers, while including customary commissions, reflect neither possible other fees nor varying compensating balance requirements.

* Market rates as of Sept. 3; bond yields as of Aug. 29.

The Soviet Economy: Main Indicators to 1982

(percent change)

	Actual						Projected		
	Average 1971-75	1975	1976	1977	1978	1979	1980	1981	1982
Gross National Product[1]	4.0	2.0	4.1	3.6	4.1	1.1	3.4	3.0	3.0
Industrial production[1]	5.9	5.6	3.7	4.1	3.3	2.3	3.4	3.5	3.4
Agricultural output[1]	2.1[2]	−8.3	7.6	3.4	4.7	−3.7	3.6	1.2	1.9
New capital investment	7.0	8.7	4.5	3.7	5.7	2.0	3.7	3.6	3.9
Real consumption (public and private)	3.9	4.8	2.8	3.3	2.6	2.0	2.7	2.4	2.3
General price level	1.8	1.7	1.9	1.0	1.7	1.7	2.0	2.0	2.0

Source: Projection of SOVMOD V, August 1980.

Notes: [1] Rates of growth using Western estimates of output, national product, etc. tend to be somewhat lower than Soviet official estimates because of differences in classification and weighting.
[2] Annual growth of five-year moving averages for 1970 and 1975.

USSR Looks for Moderate Recovery in 1980

The Soviet economy performed poorly in 1979. National income rose only 2%, with industrial production up 3.4% and agricultural output down 4%. The total volume of investment grew only 1%. The contributing factors included a poor grain harvest, a severe winter that cut energy production while boosting demand, and critical bottlenecks in freight transportation.

The major bright spot was foreign trade. The trade gap with the West narrowed to $1.1 billion from $3.3 billion in 1978; exports soared by 45%, mainly the result of higher oil prices and increased sales of natural gas to Western Europe. The Soviet Union's traditional trade surplus with developing countries widened to $4.7 billion.

The Soviet annual plan for 1980 projects a recovery from the economic malaise of 1979. National income is targeted to rise 4%, based on a 4.5% jump in industrial output and an 8.8% rise in agricultural production.

The Soviet economy should indeed rebound in 1980. This expectation is based on four major influences on Soviet economic performance this year: increased domestic capital spending as the five-year plan draws to a close; the economic slowdown in the West; the anticipated recovery from harsh winter conditions and a dismal agricultural showing in 1979; and the impact of Western actions taken in the wake of the invasion of Afghanistan. The Soviet economy is estimated to register national income growth of about 4% this year (3½% GNP growth, by Western measures).

Industrial output during the first half was 4.7% above the year-earlier level. On the agricultural front, crop production is projected to rise 9% as a result of increased acreage and better weather. A grain harvest of 210-215 million metric tons is anticipated, up from 179 million tons in 1979, but still below the 1978 record of 235 million. Meat production this year, however, is projected to decline 4% to 14.8-15.0 million metric tons. This drop is attributable mainly to a fall in slaughter weights, as mid-1980 herd levels actually remain higher than a year earlier. Milk and butter production have been reduced even more sharply during the first half of 1980.

Growth of new capital investment is expected to be 3% in 1980, with a 4% rise already registered in the first half of the year. This should restrain real household income and consumption growth to approximately 2½%.

Soviet foreign trade in 1980 will be affected—for better and worse—by higher average prices for energy and metals in world markets, economic slowdowns abroad, U.S. restrictions on Soviet grain purchases, strong domestic demand for machinery and materials from abroad, and a reduced volume of petroleum exports to the West.

On balance, total exports to the West are projected to rise to over $20 billion, while imports will reach $23 billion. Soviet purchases of grain from developing countries will boost the total hard-currency trade deficit to approximately $4.5 billion in 1980. (Exports to the West during the first quarter were 75% higher than in 1979, while imports were up only 25%. This large jump in export receipts, however, was largely the result of the doubling of world oil prices and will not be sustained for the year.)

The overall Soviet current-account balance is expected to remain in surplus throughout 1980, owing to windfall gains from oil and gold sales and U.S. restrictions on Soviet grain purchases. With only moderate growth in official credits from Western governments, Soviet net debt to commercial banks will continue to decline. The estimated debt-service ratio has already fallen to less than 20%, even excluding hard-currency revenues of $4 billion from gold and arms export sales.

It is widely held that by the early 1980s, energy will become the major constraint on Soviet economic growth, with perhaps dramatic consequences for domestic politics and foreign policy. This view, however, tends to overestimate the decline ahead for oil production and underestimate the potential for inter-fuel substitution and energy conservation within the USSR and Eastern Europe. It also implies too large an impact of energy on long-run economic growth.

It is now clear that the USSR reaped an energy windfall during the 1970s, thanks to its West Siberian oil and OPEC pricing policies, and that such windfall earnings are unlikely to be seen again in the 1980s. Nonetheless, it is most likely that Soviet oil output will remain at about 10-12 million barrels per day through much of the decade (compared with an average of about 11.8 million barrels in 1979). This contrasts with some forecasts that oil output will fall to eight million barrels per day or less.

If oil production is in fact sustained at 12 million barrels per day through 1985, energy production will advance by about 2½% each year, and Soviet GNP will rise by about 3% per annum through 1985 (given normal weather conditions). With domestic oil consumption growth of only 1%—and gains in natural gas, nuclear, and hydroelectric power—the Soviet balance of payments will remain strong. Accordingly, net external debt would not rise through 1985, and the debt-service ratio would remain below 20%. If, however, oil output drops to 10 million barrels per day by 1985, domestic energy growth would fall to only 1½% per annum and exports to the West and the CMEA nations would be reduced. This scenario would necessitate an accommodating drop in annual GNP growth to 2½%, an extra $10 billion in external debt by 1985, and a moderate rise in the debt-service ratio.

Donald W. Green

Exchange Rate Protectionism

There is at present an ongoing debate in the United States as to whether U.S. economic policies should become more protectionist. Some industries are pressing for protection from what they consider to be unfair competition or foreign encroachment.

Many of these same industries calling for protection have, however, received support from exchange-rate policies that have resulted in a decade of dollar weakness. The "veiled" protection provided by this depreciation has been very real, albeit less apparent. It has arisen from monetary and fiscal policies not specifically designed to protect particular industries. Nonetheless, it has promoted the interests of certain U.S. industries at the expense of other industries (and consumers) just as effectively as legislated trade barriers. At the same time, such "exchange-rate protectionism" may have also contributed to exchange-rate instability by shifting long-run equilibrium exchange rates.

Long-run equilibrium exchange rates—the relative price of national currencies—are determined by relative supplies and demands for currencies, both at home and abroad. Long-run supply is determined by the policy actions of a country's monetary authorities, while long-run demand is determined by such variables as prices, interest rates, and GNP.

Certain industries in a particular country, owing to endowments of natural resources or superior technology, possess a *comparative* advantage over their foreign competitors in certain products. Presumably, trade with foreign countries increases the productivity of a country's resources by permitting a concentration of production in those industries where a comparative advantage exists.

In an unprotected market, an industry's comparative advantage gives rise to a *competitive* advantage, which in turn arises from the industry's pricing policies. For example, suppose that, because of more efficient technology, Japanese industry A has a comparative advantage over U.S. industry B in producing a specific product. Industry A's comparative advantage would show up as a competitive advantage if industry A charged a lower price than industry B, or if its profits were higher.

The exchange rate, however, is crucial in determining whether a particular industry translates its comparative advantage into a competitive advantage. But although the exchange rate directly affects specific industries, it is an external factor beyond any single industry's control. Using the example above, suppose U.S. monetary policy (relative to Japanese) induces a dollar depreciation. With Americans receiving less yen per dollar and Japanese receiving more dollars per yen for a particular period of time, the exchange-rate depreciation increases the price of the product imported from Japan and decreases the price of the product exported to Japan. Consequently, the policy-induced exchange-rate depreciation lessens, or even obliterates, Japanese industry A's competitive advantage, transferring it to U.S. industry B where no comparative advantage exists.

Thus, an independent U.S. monetary policy action essentially imposes a non-legislated tariff on Japanese imports. And this policy-induced exchange-rate protection is as "artificial" as any legislated form of trade protection in that resultant market prices obfuscate industrial pricing behavior.

The cost of exchange protectionism

In any economy, there are market participants who prefer either a higher or a lower exchange rate. Consumers, as well as producers who import inputs to production, prefer exchange-rate appreciation. A depreciation is favored by exporters who benefit from the reduced price of their product abroad and by producers competing with foreign products in the domestic market.

Exchange-rate protection will thus be costly to those groups benefiting from appreciation. It also has a broader impact by altering the relative industrial shares of a country's GNP. A depreciation will lower domestic production in industries that utilize foreign inputs in their production processes, while boosting production in industries whose final product competes with the foreign counterpart in domestic and foreign markets. Consequently, industries benefiting will increase their relative share of national product at the expense of those industries (and consumers) that would benefit from a currency appreciation.

A policy-induced depreciation also has repercussions abroad, where a defacto currency appreciation is manifested. It alters the relative shares of the foreign country's national product, although the inter-industry transfer is reversed. Foreign consumers become better off, obtaining lower cost imports, as do foreign industries that import inputs to their production processes. Again, these two groups gain at the expense of exporters and producers competing with foreign products.

If the protected domestic industries are those with relatively obsolete technology and low productivity, then long-run, domestic economic growth is impaired. Consequently, a policy-induced depreciation may lead to further real exchange-rate depreciation and instability in the long-run equilibrium exchange rate by increasing foreign economic productivity relative to domestic productivity. This begins a vicious cycle in which further exchange-rate depreciation is triggered and gaps in relative productivity growth are widened.

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